UNCLASSIFIED VERSION

Office of Inspector General

March 16, 2011

MEMORANDUM

TO: USAID/Afghanistan Director, Earl W. Gast

FROM: OIG/Afghanistan Director, Tim Cox /s/

SUBJECT: Review of USAID/Afghanistan's Bank Supervision Assistance Activities and the Kabul Bank Crisis (Report No. F-306-11-003-S)

This memorandum is our report on the subject review. We have carefully considered management's comments on the draft report, and we have included the management comments in Appendix II.

On the basis of information provided by the Acting Assistant Director, Office of Afghanistan and Pakistan Affairs, management decisions have been made on all four of the report recommendations. Please coordinate final action with the Audit Performance and Compliance Division (M/CFO/APC).

We would like to express our appreciation to you and your staff for the cooperation and assistance extended to us during this review.

U.S. Agency for International Development
Office of Inspector General
Country Office Afghanistan
U.S. Embassy
Kabul, Afghanistan
www.usaid.gov/oig

SUMMARY

Since 2003, USAID/Afghanistan has supported a number of capacity-building activities at the Afghanistan Central Bank (DAB) to help DAB regulate the banking sector. Currently, Deloitte[1] provides DAB technical assistance in bank supervision and examination through a $92 million task order for the Economic Growth and Governance Initiative, which includes many activities in addition to bank supervision and examination. The purpose of the task order was to increase Afghanistan's ability to develop and implement sound economic and regulatory policies that provide the foundation for private sector growth in a market economy. According to Deloitte's work plan, one of the main goals of the assistance Deloitte provided to DAB was to assist DAB in fulfilling its statutory responsibilities ~~to~~ promote the stability and contribution to economic growth of the financial sector and to prevent avoidable losses." Deloitte provided onsite technical advisors at DAB's Directorate for Financial Supervision.

After the run on Kabul Bank, senior officials in the U.S. Embassy raised concerns about Deloitte's performance. Specifically, they were concerned that Deloitte staff did not warn the U.S. Government about looming problems at Kabul Bank before the first news reports broke in February 2010. They also questioned Deloitte's effectiveness and performance because Deloitte staff had provided bank supervision assistance to DAB for 7 years, yet DAB supervisors were unable to prevent the near collapse of Afghanistan's largest bank. In January 2011, USAID/Afghanistan requested the assistance of the Office of Inspector General (OIG) in determining whether USAID or Deloitte staff members were negligent in failing to report the Kabul Bank fraud.

In response to USAID/Afghanistan's request, OIG/Afghanistan conducted this review to determine:

- What opportunities USAID and contractor staff had to learn of fraudulent activities at Kabul Bank through USAID's Economic Growth and Governance Initiative and its predecessor, the Economic Growth and Private Sector Strengthening Activity.
- How staff learned of the fraud.
- What actions staff members took once they became aware of the fraud.
- Whether USAID's oversight of its contractor was adequate.

What opportunities did USAID and contractor staff have to learn of fraudulent activities at Kabul Bank? BearingPoint and Deloitte advisers who were embedded at DAB had several opportunities to learn about fraudulent activities at Kabul Bank over a span of 2 years before the run on Kabul Bank in early September 2010. Because contractors did not keep USAID/Afghanistan fully informed of developments at DAB, USAID staff had fewer opportunities to learn of the fraud. BearingPoint and Deloitte staff could have been more aggressive in following up on indications of serious problems at Kabul Bank. The most important opportunities to learn of the fraud are detailed below:

[1] In May 2009, BearingPoint sold its public services business to Deloitte. The same key advisors who worked for BearingPoint continued to provide advisory services to DAB under USAID's contract with Deloitte.

- **November 2008.** BearingPoint's onsite bank examination adviser received two death threats apparently in conjunction with an examination of Kabul Bank and another bank.

- **May-July 2009.** BearingPoint and Deloitte advisers encountered indications of political interference in financial supervision functions. For example, in a training class, a trainer stated that DAB had the power to remove the management of Kabul Bank. Trainees responded that, in reality, Kabul Bank had the power to remove DAB's management.

- **November 2009.** The DAB governor raised serious concerns to Deloitte's lead adviser about Kabul Bank's behavior and the financial condition of bank shareholders.

- **December 2009.** According to Deloitte, rumors circulated that Kabul Bank shareholders had invested in Dubai real estate using funds supplied by Kabul Bank.

- **January 2010.** DAB performed a regular onsite examination of Kabul Bank, and the DAB governor and the acting director of the Directorate for Financial Supervision instructed the examiners to look for insider abuses. The examination team was reportedly indirectly threatened by Kabul Bank management.

- **February 2010.** A Washington Post article cited insider lending abuses and possible purchase of Dubai real estate with funds from Kabul Bank. The article was discussed at length at DAB, and Deloitte advisers met with the DAB governor to plan a response.

- **March 2010.** The examination of Kabul Bank that began in January was completed, but the Directorate for Financial Supervision urged its examiners to dig deeper. Efforts to intimidate DAB officials intensified.

How did USAID staff and its contractors learn of the fraud? Nearly all of the USAID staff members we interviewed stated that they learned of the fraud through the *Washington Post* article in February 2010. One USAID staff member indicated that the existence of fraud at Kabul Bank was widely believed to exist as early as 2008, even though no specific evidence of the fraud was available at that time. According to key Deloitte staff members involved in providing banking supervision assistance to DAB, they learned of the fraud either through the *Washington Post* article published on February 22, 2010, or through the numerous news articles that appeared almost simultaneously with the run on Kabul Bank in August and September 2010. However, they acknowledged the existence of indications of fraud before that date.

What actions did USAID and contractor staff members take once they became aware of the fraud? The February 2010 Washington Post article was widely discussed at the U.S. Embassy, including by USAID and Treasury Department officials. Their recollections and perceptions of events differed somewhat. For their part, USAID officials indicated that they understood that the Treasury Department would take the lead in responding to the February 2010 news article detailing insider lending abuses and irregular investments in Dubai real estate. On February 24, 2010, the DAB governor asked the Treasury Department to arrange for a forensic audit of Kabul Bank and a second bank that was also of concern to DAB, but Treasury was initially unable to find a firm that would undertake such an audit and then the Government of Afghanistan decided to pursue audit options that would not involve the U.S.

Government. Treasury officials, in contrast, indicated that it was difficult for them to persuade USAID to engage in responding to the news article.

Deloitte officials indicated to us that, in the aftermath of the February 2010 news article, they began to work with the DAB Directorate for Financial Supervision to plan a response.

Was USAID's oversight of its contractor adequate? According to USAID's Automated Directives System (ADS) 203.3.2, Assessing and Learning," missions and their offices are responsible for monitoring a contractor's performance in achieving the contract's purpose. ADS 302.3.7.1a, Direct Contracting," Mandatory Reference: –Procedures for Designating the Contracting Officer's Technical Representative (COTR) for Contracts and Task Orders," states that the COTR is in a unique position to monitor how well the contractor is progressing toward achieving the contract's purpose and is responsible for providing technical liaison between the contractor and the contracting officer, a function critical to ensuring good contract performance. However, USAID/Afghanistan's oversight of the task order with Deloitte was weak. Because the mission was short-staffed, it did not have adequate technical expertise to recognize the warning signals at Kabul Bank or to provide adequate direction to Deloitte. As a result, USAID lost opportunities to take appropriate actions and work with Deloitte, Treasury, State, DAB, and the donor community to contain the problems at Kabul Bank.

The next section of this report provides details on the following review results:

- BearingPoint and Deloitte advisers who were embedded at DAB encountered fraud indications at Kabul Bank on a number of occasions over a span of 2 years before the run on Kabul Bank in early September 2010. However, they did not aggressively follow up on indications of serious problems at Kabul Bank (page 5).

- Deloitte advisers did not report fraud indicators at Kabul Bank to USAID, and the mission did not have a policy requiring contractors and grantees to report indications of fraud in host government institutions or possible problems that could reasonably be considered to be of foreign policy interest to USAID and the U.S. Government (page 7).

- USAID/Afghanistan's management of its task order with Deloitte was weak. If senior program managers and technical experts had been on staff at the mission, USAID would have had greater capacity to detect deficiencies in Deloitte's technical assistance activities, to question Deloitte advisers' written and oral reports, and to delve more deeply into those reports, rather than accepting them at face value (page 8).

To address these issues, this report recommends that USAID/Afghanistan:

- Develop and implement an action plan to address the performance issues with the bank supervision and examination assistance provided to the Afghanistan Central Bank by Deloitte (page 7).

- Arrange for more robust bank supervision and examination assistance, including onsite examination assistance and fraud detection training at DAB (page 7).

- Implement a written policy that clarifies the responsibilities of USAID contractors and grantees to report on indications of fraud in host-country institutions or other matters that

could reasonably be expected to be of foreign policy interest to the U.S. Government (page 8).

- Correct deficiencies in its management of its bank supervision and assistance activities (page 9).

Comments on the draft report were provided by the Acting Assistant Administrator, Office of Afghanistan and Pakistan Affairs. These comments expressed agreement with the report recommendations and indicated that USAID/Afghanistan has decided to terminate the bank supervision component of its task order with Deloitte. However, the comments stated, Deloitte cannot be held responsible for the fraud that occurred at Kabul Bank. The comments also provided additional information and perspectives on some of the events described in the report (pages 10 and 13).

Appendix I contains a discussion of the review's scope and methodology, Appendix II presents management comments on the draft report, and Appendix III contains a timeline of key events associated with the Kabul Bank crisis.

REVIEW RESULTS

Deloitte Advisers Did Not Follow Up Aggressively on Fraud Indicators

USAID awarded Deloitte a $92 million task order for the Economic Growth and Governance Initiative because Deloitte promised to provide a senior team that had substantial experience, strong institutional capacity, extensive knowledge, and positive performance implementing economic policy reform programs of similar scale and magnitude. Because of Deloitte's experience and credentials, USAID had a reasonable expectation that it could rely on the Deloitte experts to provide technical assistance to DAB in bank supervision and examination.

BearingPoint and Deloitte advisers who were embedded at DAB had encountered fraud indications at Kabul Bank on a number of occasions over a span of 2 years before the run on Kabul Bank in early September 2010. However, they could have been more aggressive in following up on indications of serious problems at Kabul Bank. The most important opportunities to learn of the fraud are detailed below:

- In November 2008, one BearingPoint adviser received two death threats, apparently in conjunction with an onsite examination of Kabul Bank and another bank. With USAID's concurrence, BearingPoint discontinued participation in onsite bank examinations, and limited its technical assistance to classroom training, coaching, and reviewing information obtained by bank examiners. Both USAID and BearingPoint dismissed the death threats as related to operating in a dangerous war zone environment rather than as a red flag signaling a high risk of irregularities or problems at Kabul Bank. A senior USAID official with extensive banking experience later explained that USAID and its advisers should have reinforced offsite assistance for bank examinations, taken other steps to search for possible fraud at Kabul Bank, or discontinued assistance altogether.

- From May through July 2009, BearingPoint advisers encountered indications of interference in financial supervision functions. During a training course on enforcement actions, the advisers came to sense that there was something different about Kabul Bank. For example, the DAB examiners looked incredulous when the adviser suggested that DAB had the power to remove bank management. The adviser probed the views of the examiners by asking, ―You do not think DAB can remove the chief executive officer of Kabul Bank?" The response from the examiners was, ―He can remove us."

- In November 2009, the DAB governor raised serious concerns to Deloitte's lead adviser about Kabul Bank's behavior and the financial condition of bank shareholders. The lead adviser asked for more details, but did not follow up with the DAB governor or bank examiners.

- In December 2009, Deloitte advisers heard rumors—later found to be true—from DAB that Kabul Bank owned Pamir Airways and that the shareholders had purchased properties in Dubai with funds supplied by the Bank. Deloitte's lead adviser explained that he did not take the DAB governor's concerns or rumors about Kabul Bank seriously because such talk is common in Afghanistan and usually amounts to nothing. Deloitte did not follow up or raise these issues to USAID.

- In January 2010, DAB started conducting a regular onsite examination of Kabul Bank, and the DAB governor instructed the examiners to look for insider loan abuses. The examination team reportedly was indirectly threatened by Kabul Bank management. The rumors and reported threats against the examiners should have been recognized as additional red flags signaling a high risk of fraud at Kabul Bank. Further, according to a Deloitte document, its advisers participated in several discussions with DAB's bank examiners about abusive shareholder involvement in Kabul Bank. Again, no evidence emerged showing that Deloitte advisers had taken any actions or communicated their concerns to USAID.

- On February 22, 2010, the Washington Post published an article citing alleged insider lending abuse and possible purchase of properties in Dubai with funds from Kabul Bank. The article stimulated conversation at DAB and among U.S. Embassy officials, including those representing State, USAID, and Treasury. Recollections of responsible officials differ over what role USAID was supposed to take in responding to the allegations about Kabul Bank. USAID officials indicated they were told that Treasury would take the lead, whereas Treasury officials indicated that they could not persuade USAID to be more engaged. Deloitte advisers met with the DAB governor to plan a response. The DAB governor urged his examiners to look for support for these allegations, but examiners reportedly found none. The Governor asked the Treasury to arrange a forensic audit of Kabul Bank and Azizi Bank. However, the forensic audit was not performed because Treasury was initially unable to find a firm that would undertake such an audit and then the Government of Afghanistan decided to pursue audit options that would not involve the U.S. Government.

- In March 2010, the examination of Kabul Bank that began in January was completed, but the DAB's Directorate for Financial Supervision urged its examiners to dig deeper. Meanwhile, according to USAID officials, the Deloitte advisers remained detached, providing only theoretical advice instead of lending hands-on assistance to find evidence of the fraud that seemingly everyone believed exists. Efforts to intimidate DAB's examiners intensified. The Deloitte advisers stood back because they thought that Treasury had taken the lead with conducting a forensic audit of Kabul Bank. USAID did not provide instructions to Deloitte on assisting DAB examiners to dig deeper. According to a former USAID/Afghanistan official close to the situation, USAID's work was not focused on Kabul Bank mostly because the mission was trying to strengthen the whole banking sector, but also because the mission believed that the U.S. Embassy's Coordinating Director for Development and Economic Affairs and Treasury officials were focusing on the allegations related to Kabul Bank.

Deloitte's lead adviser indicated that his professional judgment and risk tolerance were probably clouded by the Afghanistan context of incessant rumors of fraud and corruption and that consequently he did not take the fraud indications seriously. At the time, he thought that the Kabul Bank issues, if any, could be contained. Also, USAID staff members were too inexperienced or too busy to ask appropriate questions about this part of Deloitte's work at DAB.

Because Deloitte staff did not follow up aggressively on indications of fraud at Kabul Bank, Deloitte and the mission lost opportunities to contain the problems at Kabul Bank.

In hindsight, Deloitte's lead adviser acknowledged that Deloitte should have taken more aggressive actions in November 2009, such as resuming participation by Deloitte's advisers in onsite bank examinations alongside the DAB examiners. This practice was suspended in November 2008 because an adviser received death threats. The lead adviser said that if

Deloitte's onsite assistance had restarted in November 2009, the fraud could have been detected earlier, and the magnitude of losses would have been smaller.

Further, in a written communication to USAID dated September 27, 2010, Deloitte's lead adviser wrote:

> …[I]t is clear that the examiner training in fraud detection, which was planned well in advance of the current crisis, should have begun sooner. Examiners are not normally trained in fraud detection, and fraud is often not even spotted at banks until it has become so widespread as to threaten solvency. However, there are techniques that could have been applied to uncover at least some of the abuses.

***Recommendation 1**. We recommend that USAID/Afghanistan develop and implement an action plan to address the performance issues with the bank supervision and examination assistance provided to the Afghanistan Central Bank by Deloitte.*

***Recommendation 2.** We recommend that USAID/Afghanistan arrange for more robust Assistance to the Afghanistan Central Bank in bank supervision and examination, including onsite examination assistance and fraud detection training.*

Deloitte Advisers Did Not Report Fraud Indicators to USAID

According to USAID's Deputy General Counsel, as a U.S. Government contractor embedded at DAB, Deloitte had an implied obligation under the task order to report problems or concerns to USAID about Kabul Bank, Afghanistan's largest bank.

In relation to the previous finding, Deloitte's lead adviser explained that he withheld information on indications of fraud at Kabul Bank from USAID because he wanted to preserve confidentiality in his advisory relationship with DAB. However, no formal confidentiality agreement existed between Deloitte and DAB.

Deloitte's lead adviser also indicated that his professional judgment and risk tolerance were probably clouded by the Afghanistan context of incessant rumor of fraud and corruption and that consequently he did not take the fraud indications seriously. At the time, he thought that the Kabul Bank issues, if any, could be contained.

Finally, the mission did not have a policy requiring its contractors and grantees to report indications of fraud in host-government institutions or possible problems that could reasonably be considered to be of foreign policy interest to USAID and the U.S. Government.

A senior USAID official with extensive banking experience explained, however, that someone with technical experience in the field would have been more likely to identify rumors, questionable items in regular reports, and questionable statements as fraud indicators, prompting an appropriate response from the mission.

Recommendation 3. *We recommend that USAID/Afghanistan implement a written policy clarifying the responsibilities of USAID contractors and grantees to report on indications of fraud in host-country institutions or other matters that could reasonably be expected to be of foreign policy interest to the U. S. Government.*

USAID's Management of Its Task Order with Deloitte Was Weak

ADS 203.3.2, "Assessing and Learning," states that missions and their offices are responsible for monitoring a contractor's performance in achieving the contract's purpose. ADS 302.3.7.1 a, "Direct Contracting," Mandatory Reference: "Procedures for Designating the Contracting Officer's Technical Representative (COTR) for Contracts and Task Orders," states that the COTR is in a unique position to monitor how well the contractor is progressing toward achieving the contract's purpose and is responsible for providing technical liaison between the contractor and the contracting officer, a function critical to ensuring good contract performance.

When the current mission director arrived in June 2010, his attention focused on USAID/Afghanistan's capacity to manage and provide oversight of highly technical bank supervision activities implemented by its contractor, Deloitte, at DAB. This focus heightened after the Kabul Bank crisis broke in September 2010. The task order with Deloitte for the Economic Growth and Governance Initiative was for a 5-year, $92 million project with three major components and 21 work streams with diverse requirements that was managed by USAID/Afghanistan's Office of Economic Growth. In August 2009, when USAID issued the task order, the Office of Economic Growth had only four U.S. direct-hire staff and none with experience in the banking sector. For the most part, only one U.S. direct hire was managing the task order at any given time, with some assistance from Foreign Service National staff.

Further contributing to the mission's challenges to provide effective oversight of Deloitte, a former COTR for the Deloitte task order stated that during a typical workweek, he spent 50 to 70 percent of his time drafting memorandums and cables for the U.S. Embassy, reducing his time for program oversight. He kept detailed timesheets of daily work activities. The COTR explained that such competing work demands, combined with the mission's lack of technical expertise, created overreliance on the Deloitte advisers to manage the bank supervision assistance activities, with little oversight provided by USAID. USAID staff members stated that had they not faced the burden of managing a large task order with limited resources, they would have been in a better position to provide proactive and robust oversight of the Deloitte advisers. As one USAID official put it, "Deloitte was managing USAID, rather than the other way around."

Generally, COTRs monitor contractor performance and verify that it conforms to the technical requirements and quality standards agreed to in the contract. COTRs do this by maintaining regular contact and liaison and by conducting frequent site visits with the contractor. Yet according to a former COTR for the Deloitte task order, mission management focused on program spending, financial pipelines, and burn rates, rather than on monitoring and achieving program results. A former USAID/Afghanistan staff member stated in a memo that the mission gave the Office of Economic Growth only 24 hours to review a proposed Deloitte work plan—insufficient time to provide thoughtful review and comment. Finally, at the entrance conference for this review, USAID/Afghanistan officials did not take a position on whether Deloitte's performance was satisfactory or unsatisfactory, providing further evidence of inadequate management.

For years, USAID has faced difficulty in attracting staff to Afghanistan who have the appropriate levels of experience and skills. A former mission director for USAID/Afghanistan stated that the staffing situation in Afghanistan reflected what he considered to be an ongoing problem for USAID, especially for programs in war zones—not enough senior people at USAID who have the experience to manage large, substantive, technically challenging projects. Current USAID/Afghanistan leadership agreed with this assessment and explained that steps have been and continue to be taken to remedy that situation. For example, a recently completed reorganization in the Office of Economic Growth added one technical adviser position. As noted above, a senior USAID official with extensive banking experience said that had the mission had senior program managers and technical experts, USAID would have had greater capacity to detect deficiencies in Deloitte's technical assistance activities, to question Deloitte advisers' written and oral reports, and to delve more deeply into those reports, rather than accepting them at face value. The official also said that someone with technical experience in the field would have been more likely to identify rumors, questionable items in regular reports, or questionable statements as fraud indicators, prompting an appropriate response from the mission.

As a result, USAID lost opportunities to take appropriate actions and work with Deloitte, Treasury, State, DAB, and the donor community to contain the problems at Kabul.

Recommendation 4. *We recommend that USAID/Afghanistan correct the deficiencies in its management of its bank supervision and assistance activities.*

EVALUATION OF MANAGEMENT COMMENTS

Management comments on the draft report were provided by the Acting Assistant Administrator, Office of Afghanistan and Pakistan Affairs. These comments expressed agreement with the report recommendations and indicated that USAID/Afghanistan has decided to terminate the bank supervision component of its task order with Deloitte. However, the comments stated, Deloitte cannot be held responsible for the fraud that occurred at Kabul Bank. The comments also provided additional information and perspectives concerning some of the events discussed in the report. Management comments in their entirety are presented in Appendix II.

Regarding Recommendation 1, which is that USAID/Afghanistan address the performance issues with the bank supervision and examination assistance provided to the Afghanistan Central Bank by Deloitte, the Office of Afghanistan and Pakistan Affairs indicated that USAID/Afghanistan has decided to terminate the bank supervision component of the task order with Deloitte. In addition, for any ongoing or future activities with the Central Bank, USAID/Afghanistan will strengthen contractor oversight and ensure that USAID contractors working with the Central Bank (1) adopt a proactive stance in identifying and reporting to USAID fraud, waste, or abuse, (2) educate its personnel and embedded consultants on the unique operating culture and challenges of the Afghan financial sector, (3) engage the Afghan banking system to creatively address problems in light of these challenges, and (4) work with the Central Bank to develop policies on business ethics and train bank staff on these policies.

For Recommendation 2, which is that USAID/Afghanistan arrange for more robust assistance to the Afghanistan Central Bank in bank supervision and examination, the Office of Afghanistan and Pakistan Affairs stated that any continued assistance to the Central Bank will address a number of key concerns including commitment by the Central Bank to combating waste, fraud and abuse; commitment by the Government of Afghanistan to Central Bank independence; the ability of the Central Bank to attract qualified staff; commitment to strengthened bank supervision; and Government of Afghanistan support for a Central Bank decision to place Kabul Bank in receivership.

With respect to Recommendation 3, which is that the mission clarify the responsibilities of contractors and grantees for reporting on indications of fraud in host-country institutions or other matters that could reasonably be expected to be of foreign policy interest to the U.S. Government, the Office of Afghanistan and Pakistan Affairs stated that USAID/Afghanistan and other concerned USAID offices will develop a written policy to implement the recommendation.

For Recommendation 4, which is that USAID/Afghanistan correct the deficiencies in its management of its bank supervision and assistance activities, the Office of Afghanistan and Pakistan Affairs indicated that USAID/Afghanistan has brought in a senior financial sector expert to guide the work of the Office of Economic Growth and that it plans to obtain the services of two additional financial sector experts.

The target completion date for all of the actions described above is May 31, 2011.

Based on the information provided by the Office of Afghanistan and Pakistan Affairs, management decisions have been reached on all four report recommendations.

SCOPE AND METHODOLOGY

Scope

The Office of Inspector General's Office in Afghanistan conducted this review in accordance with the general standards in Chapter 3 and the evidence and documentation standards in Paragraph 7.55 and Paragraphs 7.77 through 7.84 of *Government Auditing Standards*. Those standards require that we obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions, based on our review objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on the review objectives.

The review covered USAID/Afghanistan's capacity building activities at DAB from September 2005 through January 2011. The capacity building activities were implemented by BearingPoint through a $79 million contract for the Economic Growth and Private Sector Strengthening Activity which ran from September 2005 through September 2009 and by Deloitte through a $92 million USAID task order for the Economic Growth and Governance Initiative which began on August 15, 2009, and is scheduled to end on August 14, 2014. It was awarded as a 1-year task order with 4 option years. As of January 31, 2011, about $47 million was obligated for the Economic Growth and Governance Initiative and $112 million was spent for the two contracts.

The review was performed in Afghanistan from January 13 through February 3, 2011. In Kabul, fieldwork was conducted at the U.S. Embassy compound. The fieldwork included interviews with U.S. Government, DAB, and Deloitte officials, as well as the review of relevant documentation as outlined in the methodology section below.

Methodology

To answer the review objectives, we interviewed USAID, Treasury Department, Deloitte, and DAB officials. We also contacted USAID staff formerly posted in Afghanistan who had oversight responsibilities for BearingPoint and Deloitte and who had direct knowledge of the Kabul Bank crisis. We reviewed and analyzed relevant documents and data at the mission. Documents and data included USAID contracts and task orders; USAID and contractor work plans, action plans, performance management plans, monitoring reports, progress reports, memoranda, and e-mail communications; DAB memorandums and reports; USAID financial reports; U.S. Embassy cables; and news articles.

In developing areas to examine and tests to perform, we considered standards and practices for bank supervision and examination from the U.S. Comptroller of the Currency's *Handbook for Large Bank Supervision*.

MANAGEMENT COMMENTS

USAID | AFGHANISTAN
FROM THE AMERICAN PEOPLE

MEMORANDUM

TO:	Timothy Cox, OIG/Afghanistan Director
FROM:	David McCloud, Acting Assistant to the Administrator, Office of Afghanistan and Pakistan Affairs /s/
DATE:	March 14, 2011
SUBJECT:	USAID Response to the draft OIG Report Reviewing USAID/Kabul's Bank Supervision Assistance Activities and the Kabul Bank Crisis (Report No. F-306-11-00X-S)

This memorandum is USAID's response to the draft OIG report reviewing USAID/Afghanistan's Bank Supervision Assistance Activities and the Kabul Bank Crisis (Report No. F-306-11-00X-S) ("draft RIG report") and represents the views of both Washington and the field. USAID appreciates the time and effort of the OIG staff in carrying out this report and the cooperative manner in which the audit was conducted.

General Comments:

In the immediate aftermath of the Kabul Bank crisis, USAID requested this review of USAID and Deloitte's efforts - as providers of training and technical assistance. We are grateful for the efforts of the OIG and are already taking decisive steps based on the recommendations in this report. We are pleased that the review found no indications of fraud, waste or abuse by USAID or Deloitte.

USAID/Kabul has decided to terminate the bank supervision component of the Deloitte task order. Though Deloitte cannot be held responsible for the fraud, failure, or the run on Kabul Bank, given the changed conditions on the ground, we have terminated this part of the Deloitte contract in order to ensure that our technical assistance is as effective as possible.

At the same time, it should be made clear that Deloitte could not have stopped the massive fraud that occurred at Kabul Bank. To this end, we want to underscore that USAID and Deloitte's scope of work and mandate under Component 2 of the Economic Growth and Governance Initiative ("EGGI") task order was to provide trainers and technical experts to build the capacity of the Bank Supervision unit within the Central Bank of the Government of Afghanistan, Da Afghanistan Bank ("DAB"), and not for Deloitte itself to supervise private banks. Other entities in the Government of Afghanistan and the international community also supported the Central

Bank and the various oversight and investigatory bodies involved in preventing, investigating, and responding to the Kabul Bank crisis. The Deloitte advisors worked on human capacity building efforts and skill set building for Afghan bank examiners working in the bank supervision department of the Central Bank.

The fraud committed by Kabul Bank officers and shareholders was criminal in nature, deliberately concealed by major shareholders and senior bank management. In the Fall of 2010 as the fraud within Kabul Bank came to light, USAID took several proactive steps, including the request for this OIG review. USAID also commissioned a rapid assessment to identify losses and to recommend remedies for action.

The Chairman of the Board, the CEO of Kabul Bank, and the Chief Risk Officer caused loan documentation to be fabricated for fictitious companies registered at the Afghan Investment Support Agency. Loan funds were then diverted to these individuals for their personal use. Kabul Bank's shareholder/officers' fraud and self-dealing caused these massive losses and concealed them using fake documentation and other means of obfuscation. The initial outline of this fraud and revelation of the unprecedented level of loss did not occur until the Chairman of the Board of Kabul Bank began talking with Central Bank Authorities in the summer of 2010. Notwithstanding previous rumors and comments that were being made, depositors and donors and their various assistance programs were essentially caught by surprise by the scale of the crisis.

Below are some clarifying details about alleged indicators of fraud identified in the OIG report.

The eight summary fraud indicia are listed in the same chronological order presented in the February 9, 2011 OIG Ramonas-Gast Report.

- **November 2008.** <u>BearingPoint's onsite bank examination adviser received two death threats apparently in conjunction with an examination of Kabul Bank and another bank.</u> USAID emphasizes that in 2008 the Mission was fully aware and agreed with BearingPoint discontinuing its participation in onsite bank examinations. The Mission believed that the death threats were serious as records show a dramatic increase in insurgent attacks on implementing partners during that period. The Mission and BearingPoint reached a quick, mutual agreement to send the advisor out of the country and to discontinue the practice of sending contract advisors to on-site bank examinations with Afghan bank examiners. While this on-the-job training and coaching was valuable for Afghan examiners, the Mission and BearingPoint agreed that they should perform on-site examinations themselves, supported by continued contractor-led capacity building at the Central Bank to build examination skill sets over time and to lessen dependence on foreign advisers.

- **May-July 2009.** <u>BearingPoint and Deloitte advisers encountered indications of political interference in financial supervision functions. For example, in a training class, a trainer stated that DAB had the power to remove the management of Kabul Bank. Trainees responded that, in reality, Kabul Bank had the power to remove DAB's management.</u>

Although not discussed in the draft OIG report, it was widely known in Afghanistan at the time that Kabul Bank's senior management and shareholders were politically well-connected, and this comment appears to be an expression of real-world political constraints in Afghanistan. It is not clear that this serves as an indicator of fraud.

- **November 2009.** The DAB governor raised serious concerns to Deloitte's lead adviser about Kabul Bank's behavior and the financial condition of bank shareholders.

Deloitte took some action during this period in response to the rumors. Deloitte's lead adviser drafted a memorandum to the DAB Governor dated January 7, 2010, regarding "[m]easures to reduce or eliminate shareholder involvement in bank affairs." The memorandum included recommendations on on-site supervision "enhancements" to help DAB trace funds back to shareholders. The lead adviser also sent several emails to his team of advisers regarding the need to focus on the detection of fraud and abusive loans. See emails from Deloitte lead adviser dated December 20 and 21, 2009, and January 27, 2010. Deloitte advisers also inquired and received repeated assurances from DAB examiners that the allegations of insider shareholder abuse had been investigated in targeted examinations, and no links were found between Kabul Bank's funds and the questionable investments. When Deloitte did learn of evidence about an interest-free loan issued at another bank as a result of corruption during this time period, it informed USAID promptly. See November 19, 2009, email from Deloitte to USAID.

USAID agrees that Deloitte should have aggressively reported evidence of fraud at Kabul Bank to the Mission. USAID/Afghanistan intends to formally address the scope of confidentiality between advisers and DAB, if any, and the type of information that must be shared by contractors with USAID in future contracts involving banking supervision.

- **December 2009.** According to Deloitte, rumors circulated that Kabul Bank shareholders had invested in Dubai real estate using funds supplied by Kabul Bank.

After the February 22, 2010, Washington Post article was published, Deloitte proactively proposed actions to USAID on how to respond, including proposing a forensic audit of Kabul Bank as the first and most important action. The Mission agreed with Deloitte that such an audit was crucial to detect fraud at Kabul Bank.

Following a March 7, 2010, meeting between the USG interagency and the DAB Governor, it was agreed that the USG would take the lead on procuring a US audit firm to conduct a forensic audit, but USAID would not be a participant. USAID emailed Deloitte on March 9, 2010, instructing Deloitte to "hold off on identifying a forensic accountant" since "[i]t looks like this will be picked up by someone else." Therefore Deloitte cannot be faulted for not taking action on a forensic audit after this time. During the spring and summer of 2010, Deloitte advisers did not attend meetings between US Treasury and DAB officials regarding the forensic audit. Treasury conducted a successful procurement of a firm willing to undertake the audit and was prepared to sign a contract with the firm until GIRoA indicated a desire to pursue audit options that did not involve the U.S. government.

- **January 2010.** DAB performed a regular onsite examination of Kabul Bank, and the DAB governor and the acting director of the Directorate for Financial Supervision instructed the examiners to look for insider abuses. The examination team was reportedly indirectly threatened by Kabul Bank management.

The Mission agrees that this should have raised concerns among both Deloitte advisors and the Central Bank and that USAID should have been advised. However, we note that the Central Bank apparently did not look into this allegation and did not ask the Deloitte advisors tor advice at the time. Deloitte did take action in raising the issue of insider shareholder abuses in the banking system, including Kabul Bank with both Central Bank officials and the examination staff. We agree that USAID should have been informed and that this was a missed opportunity tor USAID to provide contractor guidance on strengthening its capacity building with training on identification of fraud indicia.

- **February 2010.** A Washington Post article cited insider lending abuses and possible purchase of Dubai real estate with funds from Kabul Bank. The article was discussed at length at DAB, and Deloitte advisers met with the DAB governor to plan a response.

We would note that after this article was published, and as the OIG states in its report, the Central Bank asked its examiners to look for support for the allegations made but the examiners reportedly found none. Deloitte had many meetings with Central Bank management on a response and USAID and the Embassy country team had many meetings to discuss a coordinated response. In response to a March, 2010, letter of request from the DAB Governor Fitrat to Secretary Geithner, Treasury agreed to fund a forensic and prudential audit of Kabul bank and Azizi bank.

- **March 2010.** The examination of Kabul Bank that began in January was completed, but the Directorate tor Financial Supervision urged its examiners to dig deeper. Efforts to intimidate DAB officials intensified.

The Mission notes that Deloitte continued its capacity building and training at the Central Bank to build up capacity of the examination staff. The OIG report states that there was increased intimidation of examiners although this was not reported to USAID.

USAID/Afghanistan notes that Deloitte generally did not provide the Mission copies of examination reports of banks done by the Central Bank.

The audit performed by an affiliate of PricewaterhouseCoopers (PwC) was not directly mentioned in the body of the OIG report but it was a significant source of information to the Central Bank's examination staff. The resulting clean bill of financial health of Kabul Bank issued by PwC may have acted to delay understanding of the gravity of Kabul Bank's true financial condition both among the examination staff and the international community.

On February 10, 2010, A.F. Ferguson & Co., a Pakistani affiliate of PwC, issued an annual audit of Kabul Bank, giving an analysis of Kabul Bank's financial position as of December 31, 2009. Ferguson was contracted by Kabul Bank to perform the audit, as required by Afghan banking

law. Neither USAID nor any agency of the US Government had any role or input in this audit. The PwC audit team did not identify any fraud at Kabul Bank. In fact, it gave Kabul Bank a clean bill of health. Bank supervision departments around the world use the annual audit and the audit firm's opinion and findings to supplement their bank examination analyses. The PwC affiliate mentioned no problems at Kabul Bank and also stated that the financial information analyzed represented the condition of Kabul Bank. This "clean audit" opinion from a professional accounting and auditing firm with world-wide operations demonstrates the difficulty of identifying fraud at Kabul Bank at the time.

Mission Responses to the Report Recommendations

USAID wishes to note that we agree with all of the recommendations in this report. The efforts of the Inspector General will help us improve our technical assistance and ensure our policy and oversight of the relevant program is clear. We have already begun to implement remedies, including increasing the level of our project management leadership and staff in financial sector training and backgrounds; clarifying confidentiality standards; and terminating this component of the Deloitte task order.

Recommendation 1. We recommend that USAID/Afghanistan develop and implement an action plan to address the performance issues with the bank supervision and examination assistance provided to the Afghanistan Central Bank by Deloitte.

USAID agrees with Recommendation 1.

Actions Taken/Planned:

In the plan, for any ongoing or future activities with the Central Bank, USAID/Afghanistan will strengthen and increase oversight of the contractor working with the Central Bank. Additionally, USAID/Afghanistan will ensure that USAID contractors working with the Central Bank will (1) adopt a proactive stance in identifying and reporting to USAID fraud, waste, or abuse encountered in the Central Bank, (2) educate its personnel and embedded consultants on the unique operating culture and challenges of the Afghan financial sector, (3) engage the Afghan banking system to creatively address problems in light of such unique challenges and culture, and (4) work with the Central Bank to develop policies on business ethics and train bank staff accordingly on implementing such policies.

Target Completion Date: 05/31/2011

Based on the above, USAID/Kabul deems that a management decision has been reached on Recommendation No.1 and therefore requests your concurrence.

Recommendation 2. We recommend that USAID/Afghanistan arrange for more robust assistance to the Afghanistan Central Bank in bank supervision and examination, including on-site examination assistance and fraud detection training.

USAID agrees with Recommendation 2.

Action Taken/Planned:

Any continued USAID assistance to DAB bank supervision will be re-designed to focus on addressing the concerns below. These will be built in to a more robust program of advice and training in bank supervision policy, management and bank examination training. Key concerns to be addressed include: 1) a commitment by DAB to implement policies to strengthen ethics and combat fraud, waste and abuse, within the Central Bank and commercial banks; 2) the commitment of GIRoA to allow the DAB to operate independently, with proper bank supervisory powers, with full government funding and administrative support, and with minimal political interference; 3) the ability of DAB to recruit and retain sufficiently skilled staff to conduct its mission; 4) the willingness of DAB and GIRoA to support and execute an action plan whereby all commercial banks will be re-licensed and will be required to operate according to best practices; and, most importantly, 5) the support of GIRoA and its Presidential Administration for major reforms aimed at strengthening bank supervision in Afghanistan, such as passage of a Banking Law that will support a strong oversight role for DAB and a robust enforcement framework for addressing negligence, shareholder abuse, and criminality in the commercial banking system, and 6) GIRoA must support the DAB in its decision to put Kabul Bank into receivership, as required by both the IMF and the U.S. Government.

Target Completion Date: 05/31/2011

Based on the above, USAID deems that a management decision has been reached on Recommendation No.2 and therefore requests your concurrence.

Recommendation 3. We recommend that USAID/Afghanistan implement a written policy clarifying the responsibilities of USAID contractors and grantees to report on indications of fraud in host-country institutions or other matters that could reasonably be expected to be of foreign policy interest to the U.S. Government.

USAID agrees with Recommendation 3.

Action Taken/Planned:

USAID/Afghanistan accepts the recommendation to work on providing a written policy clarifying the responsibilities of USAID contractors and grantees to report on indications of fraud in host-country institutions as well as on other matters that could reasonably expected to be of foreign policy interest to the U.S. Government as it applies to Afghanistan. This effort is being led by the Regional Legal Advisor (RLA) and other concerned offices in USAID. Reporting responsibilities may vary depending on the nature of the project and the type of implementing partners involved.

Target Completion Date: 5/31/2011

Based on the above, USAID deems that a management decision has been reached on Recommendation No.3 and therefore requests your concurrence.

Recommendation 4. We recommend that USAID/Afghanistan correct the deficiencies in its management of its bank supervision and assistance activities.

USAID agrees with Recommendation 4.

Action Taken/Planned:

USAID/Kabul has been very sensitive to having the proper in-house expertise to manage highly technical activities, and is fully committed to making the extra effort needed to obtain such expertise. USAID/Afghanistan has already brought on board, as Director of the Office of Economic Growth, a senior financial sector expert to guide USAID's work in the financial sector. Another financial sector expert will be on board in March 2011, to serve as Chief of the Economic Policy & Governance Division. A third senior financial sector expert is being recruited to provide direct technical advice to GIRoA and DAB, as well as to manage a newly reformulated bank supervisory assistance activity on a day-to-day basis.

Target Completion Date: 5/31/2011

Based on the above, USAID deems that a management decision has been reached on Recommendation No.4 and therefore requests your concurrence.

TIMELINE OF KEY EVENTS

09/2003 – USAID/Afghanistan's assistance to the Afghanistan Central Bank (DAB) Directorate for Financial Supervision begins under a contract with BearingPoint (which sold its public sector business units to Deloitte in 2009).

2007 – With assistance from BearingPoint, the DAB Directorate for Financial Supervision conducts its first full-scope bank examinations on all 18 banks in Afghanistan.

02/2008 – An International Monetary Fund study finds that "bank supervision needs further strengthening," and USAID steps up training in the Directorate for Financial Supervision.

11/2008 – BearingPoint's onsite bank examination adviser receives two death threats apparently in conjunction with an examination of Kabul Bank and another bank. BearingPoint and USAID agree to discontinue BearingPoint's participation in onsite bank examinations. BearingPoint staff members continue to assist with the examinations through offsite training, desk reviews of examination reports, etc.

OIG comment: The death threats should have been recognized as a ~~"~~red flag" signaling a high risk of fraud at Kabul Bank. In response to this development, DAB, BearingPoint, and USAID/Afghanistan should have reinforced off-site assistance for bank examinations or taken other steps to search for fraud at Kabul Bank.

05/2009–07/2009 – BearingPoint advisers encounter indications of political interference in financial supervision functions. For example, in a training class, a trainer states that DAB has the power to remove the management of Kabul Bank. Trainees respond that, in reality, Kabul Bank has the power to remove the management of DAB.

OIG comment: With more than 5 years of financial supervision experience in Afghanistan at this point, BearingPoint surely had a good understanding of the political economy of Afghanistan even before this incident. Nonetheless, this incident reinforced the message that weaknesses in the control environment were undermining the effectiveness of regulation and other checks and balances and internal controls.

08/2009 – USAID assistance to the Directorate for Financial Supervision continues under the Economic Growth and Governance Initiative (EGGI) contract with Deloitte. Key BearingPoint staff members continue to provide the same services under the new contract with Deloitte.

08/2009–09/2009 – Routine monitoring of Kabul Bank continues. Reported regulatory capital is weak but above the required minimum and, in response to a demand by DAB, Kabul Bank agrees to raise paid-in capital.

10/2009–11/2009 – Concerned with the use of lottery-linked deposit accounts (in which account holders can win large prizes) by Kabul Bank, Azizi Bank, and a third bank, DAB and members of Parliament criticize these accounts as un-Islamic and preying on avaricious impulses.

11/2009 – The DAB governor raises serious concerns to Deloitte's lead adviser about Kabul Bank's behavior and the financial condition of bank shareholders.

Appendix III

12/2009 – Rumors circulate that Kabul Bank shareholders have invested in Dubai real estate using funds supplied by Kabul Bank. DAB staff members deny these rumors and indicate that they have been investigated and shown to be untrue. (Subsequent investigation showed that the rumors were true.)

01/2010 – DAB performs a regular onsite examination of Kabul Bank. The DAB governor and the acting director of the Directorate for Financial Supervision instruct the examiners to look for insider abuses. The examination team is reportedly indirectly threatened by Kabul Bank management.

OIG Comment: The rumors and reported threats against the examiners should have been recognized as additional red flags signaling a high risk of fraud at Kabul Bank.

02/2010 – A.F. Ferguson & Co., a member firm of Price Waterhouse Coopers, issues an unqualified opinion on Kabul Bank's financial statements for 2009.

02/22/2010 – A Washington Post article cites insider lending abuses and possible purchase of Dubai real estate with funds from Kabul Bank. The article prompts lengthy discussions at DAB and among U.S. Embassy officials, including those representing USAID and the Treasury Department. Deloitte advisers meet with the DAB governor to plan a response.

OIG Comment: Recollections of responsible officials differ over what role USAID was supposed to take in responding to the allegations about Kabul Bank. USAID officials indicate they were told that Treasury would take the lead; Treasury officials indicate that they could not persuade USAID to be more engaged.

02/2010 – The DAB governor urges his examiners to look for support for these allegations, but examiners find none. The governor asks the U.S. Treasury Department to arrange a forensic audit of Kabul Bank and Azizi Bank, but Treasury is unable to find an international accounting firm that will undertake the audit.

OIG Comment: Reportedly, communication between Treasury and USAID was poor at this time but has since improved.

03/2010 – The examination of Kabul Bank that began in January is completed, but the Directorate for Financial Supervision urges examiners to dig deeper. Efforts to intimidate DAB officials intensify. According to USAID, the Deloitte advisers remain detached, providing only theoretical advice instead of lending hands-on assistance to find evidence of the fraud that seemingly everyone believes exists. No one provides any warnings about a possible failure of Kabul Bank.

OIG Comment: USAID officials indicate that the USAID staff responsible for managing the Deloitte contract were inexperienced and overcommitted.

06/2010 – DAB passes a resolution to end all participation by shareholders and board members in bank management decisions involving the commitment of bank resources. Other actions are taken to strengthen the Banking Law and DAB's enforcement authority.

Appendix III

07/2010–08/2010 – DAB signs a memorandum of understanding with authorities in the United Arab Emirates to facilitate cross-border financial supervision and investigations.

08/2010–09/2010 – DAB places Kabul Bank under conservatorship on 8/28/2010. Further news articles cause a run on Kabul Bank.

09/2010–10/2010 – The Deputy Ambassador and the Coordinating Director for Development and Economic Affairs meet with USAID and Deloitte and later ask USAID to issue a cure notice to Deloitte. No such notice has yet been issued.

OIG Comment: At the time of our entrance conference on 01/13/2011, USAID/Afghanistan officials did not take a position on whether Deloitte's performance was satisfactory or unsatisfactory.

01/31/2011 — A New York Times article reports that fraud and mismanagement at Kabul Bank resulted in potential losses of as much as $900 million.